INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 02, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 263A.04-04, 263A.06-05, 263A.07-00
CASE-MIS No.: TAM-106669-05
Number: **200626044**
Release Date: 6/30/2006
Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
State =
Area 1 =
Area 2 =
a =
b =
c =
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ISSUE(S):

1. Whether Taxpayer's self-constructed generation, transmission, and distribution assets are produced on a routine and repetitive basis in the ordinary course of its trade or business for purposes of § 1.263A-1(h)(2)(i)(D) of the Income Tax Regulations.

2. Is a taxpayer that elects to use the simplified service cost method to determine capitalizable mixed service costs with respect to eligible property required to allocate mixed service costs to property that is not eligible for the simplified service cost method using the methods provided in § 1.263A-1(g)(4) of the Income Tax Regulations?

CONCLUSION(S):

1. Taxpayer's self-constructed generation, transmission, and distribution assets, which are described below, are not produced on a routine and repetitive basis in the ordinary course of its trade or business for purposes of § 1.263A-1(h)(2)(i)(D).

2. A taxpayer that elects to use the simplified service cost method to determine capitalizable mixed service costs with respect to eligible property is required to allocate mixed service costs to property that is not eligible for the simplified service cost method using the methods provided in § 1.263A-1(g)(4).

FACTS:

Taxpayer is a public utility that provides electric services to over m customers in State. The Area 1 and Area 2 of State are high growth areas. Accordingly, Taxpayer added approximately a new customers in 2001 and b customers in 2002. Thus, during these years Taxpayer constructed new infrastructure to service approximately c new homes each day. This new infrastructure included generation, transmission, and distribution assets to provide electric services to Taxpayer's expanding customer base, as well as to upgrade and maintain its service to existing customers. From 1987 to 2001, Taxpayer incurred production expenditures for generation, transmission, and distribution assets of $d. Approximately 65% of this amount was budgeted for expanding the size or capacity of Taxpayer's electric network. The remaining amount was mostly budgeted to improve reliability, relocate, and restore damaged facilities.

In 2003, Taxpayer incurred over e man-hours constructing, modifying, and improving its transmission and distribution system and another f man-hours constructing, modifying, and improving its generation facilities. For example, in 2003 Taxpayer installed approximately g meters, h distribution poles, i transformers, j transmission towers and poles, and k miles of conductor.

For 2001, Taxpayer filed a Form 3115 under the automatic consent procedures provided by Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and clarified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), to change its method of allocating mixed service costs from a facts-and-circumstances method to the simplified service cost method. Accordingly, Taxpayer applied the simplified service cost method beginning with the 2001 taxable year to determine its capitalizable mixed service costs incurred during the year with respect to its production of electricity, purchased assets, and self-constructed assets.

Taxpayer classified its electric plant accounts in compliance with accounting required by the Federal Energy Regulatory Commission (FERC). Accordingly, Taxpayer divided its assets into the following five reporting categories for FERC: Intangible Plant, Production or Generation Plant, Transmission Plant, Distribution Plant, and General Plant. These five categories are then subdivided into 58 FERC accounts. In 2001, Taxpayer subdivided these 58 accounts into approximately 1200 account classifications with the consent of the State Public Service Commission. The properties represented in these accounts are not necessarily fungible. Although the properties represented in these accounts are similar in nature and function, they are not identical. For example, FERC account 355 contains transmission poles and fixtures. The poles represented in the account consist of poles of various types and lengths. Moreover, the poles represented in this account were used in the construction of various projects that required specialized engineering, often required individual design, permitting, and a long construction period. For purposes of its Form 3115, when it computed its capitalizable mixed service costs under the simplified service cost method, Taxpayer did not include its general plant and intangible assets as eligible property for purposes of the method. Taxpayer does not assert that these assets are eligible property for purposes of the simplified service cost method because these assets are not produced on a routine and repetitive basis.

Taxpayer determined the total mixed service costs capitalizable with respect to eligible property under the simplified service cost method. The total capitalizable mixed service costs determined under the simplified service cost method was significantly more than were being capitalized under Taxpayer's facts-and-circumstances method. Taxpayer then allocated these capitalizable mixed service costs between its electricity inventory and the self-constructed assets. Taxpayer allocated capitalizable mixed service costs to electricity by multiplying the capitalizable mixed service costs, determined using the simplified service cost method, by the ratio of section 263A

production costs related to the production of electricity to total production costs.[1] Similarly, Taxpayer allocated capitalizable mixed service costs to self-constructed assets by multiplying the capitalizable mixed service costs by the ratio of section 263A production costs related to self-constructed assets to total production costs. Through this methodology, Taxpayer allocated a significantly larger portion of the capitalizable mixed service costs to electricity. Because Taxpayer does not maintain an ending inventory of electricity, capitalizable mixed service costs allocated to the electricity were included immediately in cost of goods sold.

As is indicated above, in applying the simplified service cost method, Taxpayer determined that its general plant and intangible assets are not eligible property for purposes of the method. Therefore, in applying the simplified service cost method Taxpayer excluded section 263A production costs associated with these assets from the numerator of the production cost allocation ratio. Taxpayer also excluded from total mixed service costs, the capitalizable mixed service costs that were associated with such property. Taxpayer had determined that for its 2001 tax year approximately 8% of its assets were not eligible property for purposes of the simplified service cost method.

The Examination Team contends that self-constructed assets are only considered as produced on a routine and repetitive basis in the ordinary course of a taxpayer's business for purposes of § 1.263A-1(h)(2)(i)(D) if the property is mass-produced or has a high degree of turnover. The Examination Team also contends that little, if any, of Taxpayer's generation, transmission, and distribution property qualifies under this section. Accordingly, the Examination Team contends that Taxpayer is not permitted to use the simplified service cost method with regard to much, if any, of its generation, transmission, and distribution assets. The Examination Team has asked us to consider the following four representative work orders that resulted in the construction of generation, transmission, and distribution assets (hereinafter Taxpayer's representative assets):

1. Work Order # n – This work order relates to the construction of a new transmission line at an estimated total cost of $o. The transmission line is comprised of approximately 300 concrete poles of various sizes, approximately 550,000 feet of conductor (wire), approximately 200,000 feet of aluminum overhead ground wire, approximately 300 units of suspension rod type insulation, and 705 units of insulator.

2. Work Order # p – This work order was for the re-powering of a unit at one of Taxpayer's generating stations and provided for the replacement of a boiler unit. The

[1] This method is not provided for in the simplified service cost method regulations. Section 1.263A-1(h) does not provide any method of allocating capitalizable mixed service costs between the various categories of eligible property or among the assets within a category. See § 1.263A-1(h). The Examination Team, however, has not challenged the methodology developed and used by Taxpayer to allocate capitalizable mixed service costs incurred with respect to eligible property between categories or among assets within a category.

work order relates to a “ten year plant site plan” that provides for converting and upgrading a power plant from oil to natural gas at an estimated total cost of $g.

3. Work Order # r – This work order provides for the addition of a spent fuel storage racks and cask crane at a nuclear power plant. The total budgeted cost of the project was $s.

4. Work Order # t – This work order provided for the acquisition of approximately 3 acres of land to expand a substation at a budgeted cost of $u.

LAW AND ANALYSIS:

Issue 1. Whether Taxpayer’s self-constructed generation, transmission, and distribution assets are produced on a routine and repetitive basis in the ordinary course of its trade or business for purposes of § 1.263A-1(h)(2)(i)(D).

Section 263A of the Internal Revenue Code provides that producers of real or tangible personal property must capitalize the direct costs and a proper share of the indirect costs of such property. For this purpose, indirect costs include service costs. See § 1.263A-1(e)(3). Service costs are a type of indirect costs that can be identified specifically with an administrative or support department and include capitalizable service costs, deductible service costs, and mixed service costs. See § 1.263A-1(e)(4). Mixed service costs include service costs that are partially allocable to production activities and partially allocable to non-production activities. See § 1.263A-1(e)(4)(ii)(C).

Taxpayers generally are required to allocate mixed service costs to property produced using reasonable factors or relationships under a direct reallocation method (as defined in § 1.263A-1(g)(4)(iii)(A)), a step-allocation method (as defined in § 1.263A-1(g)(4)(iii)(B)), or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(4).

Section 1.263A-1(h) permits taxpayers to also use a simplified method, the simplified service cost method, to determine the aggregate portion of mixed service costs incurred during the taxable year that are properly allocable to “eligible property.” Section 1.263A-1(h)(2)(i) provides that for purposes of the simplified service cost method any of the following categories of property that are subject to section 263A are eligible property:

1. Inventory property. Stock in trade or other property properly includible in the inventory of the taxpayer. See § 1.263A-2(b)(2)(i)(A).

2. Non-inventory property held for sale. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. See § 1.263A-2(b)(2)(i)(B).

3. Certain self-constructed assets. Self-constructed assets that are substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer that is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See § 1.263A-2(b)(2)(i)(C).

4. Self-constructed assets produced on a repetitive basis. Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. See § 1.263A-2(b)(2)(i)(D).

In applying the simplified service cost method, Taxpayer treated all of the separate generation, transmission, and distribution assets that it produced as well as improvements to its generation, transmission, and distribution assets, including the above representative assets, as "self-constructed assets produced on a routine and repetitive basis" (i.e., eligible property for purposes of the simplified service cost method). As indicated above, the Examination Team contends that self-constructed assets are only considered as produced on a routine and repetitive basis in the ordinary course of a taxpayer's business for purposes of § 1.263A-1(h)(2)(i)(D) if the property is mass-produced or has a high degree of turnover. Accordingly, the Examination Team contends that Taxpayer is not permitted to use the simplified service cost method with regard to much, if any, of its generation, transmission, and distribution assets, including the representative assets that are described above.

Rev. Rul. 2005-53, 2005-35 I.R.B. 425, holds that for purposes of the simplified service cost method, a taxpayer's self-constructed assets are only considered as produced on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business if the assets are either mass-produced (i.e., numerous identical goods are manufactured using standardized designs and assembly line techniques) or have a high degree of turnover. The revenue ruling further provides that in determining whether an asset is mass-produced by the taxpayer, property is considered mass produced only if it is manufactured. Accordingly, the revenue ruling provides that for this purpose mass production does not include all the terms provided in § 1.263A-2(a)(1), e.g., install and improve. In other words, property is mass-produced only if it is manufactured numerous times during the year using standardized designs and assembly line techniques. The revenue ruling also provides that for purposes of determining whether an asset is produced on a routine and repetitive basis, an asset has a high degree of turnover if the asset has a short useful life.

Taxpayer's representative assets are not mass-produced and do not have a high degree of turnover. Each of Taxpayer's representative assets required asset-specific engineering, individual design, separate permitting from various local, state and federal authorities relating to regulatory matters such as zoning and environmental law, and

often lengthy construction periods that sometimes lasted longer than a year. Moreover, these engineering and design processes and separate permits often had to be performed and obtained for each separate asset that was constructed. These are not hallmarks of assets that are mass produced. Under Rev. Rul. 2005-53, assets are only mass produced when the assets are produced numerous times during the year using assembly line techniques. See also The American Heritage Dictionary 770 (2d college ed. 1982). Moreover, an assembly line is generally thought of as a line of factory workers or equipment on which a product that is being assembled passes from one operation to another until completion. See, e.g., The American Heritage Dictionary 134 (2d college ed. 1982). Normally, when one envisions an assembly line it is not thought that the product will need reengineering or redesigning each and every time it enters the line or an operation on the line. A type of asset cannot be considered mass produced if it is redesigned each and every time it is produced. Taxpayer's representative assets are individually designed. In addition, Taxpayer's generation, transmission, and distribution assets generally have long useful lives and, therefore, do not have a high degree of turnover.[2] Accordingly, under Rev. Rul. 2005-53, Taxpayer's representative assets are not produced on a routine and repetitive basis in the ordinary course of its business and are not eligible property for purposes of the simplified service cost method.

Taxpayer argues that the criteria established in Rev. Rul. 2005-53 to determine whether self-constructed assets are produced on a routine and repetitive basis in the ordinary course of its business for purposes of § 1.263A-1(h)(2)(i)(D) is incorrect. Taxpayer asserts that the phrase "routine and repetitive" should be afforded its plain and ordinary meaning. According to Taxpayer, the plain meaning of the phrase "routine and repetitive" does not import a concept of mass production. Instead, Taxpayer suggests that because it continually constructs and improves assets used for the generation, transmission, and distribution of electricity throughout the year, all such assets and improvements should be considered self-constructed assets produced on a routine and repetitive basis for purposes of § 1.263A-1(h)(2)(i)(D).

We disagree. In general, routine means a prescribed and detailed course of action to be performed regularly or a set of customary and often mechanically performed procedures. See also The American Heritage Dictionary 1074 (2d college ed. 1982). Repetitive means doing experiencing or producing again or repeating. See also The American Heritage Dictionary 1048 (2d college ed. 1982). Although, the terms routine and repetitive overlap because each contains an element of repetition, their meanings are not identical. Moreover, as a matter of statutory construction, the terms cannot be read as synonyms because to do so renders one of them superfluous. See

[2] For example, the class life and applicable recovery period, determined under § 168(c), of assets included in asset class 49.15 of Rev. Proc. 87-56, 1987-2 C.B. 674, 685 (Electric Utility Combustion Turbine Production Plant) is 20 and 15 years, respectively. Likewise, the class life and applicable recovery period, determined under § 168(c), of assets included in asset class 49.14 of Rev. Proc. 87-56 (Electric Utility Transmission and Distribution Plant) is 30 and 20 years, respectively.

Platt v. Union Pac. R. Co., 99 U.S. 48 (1878). Instead, the words "self-constructed assets produced by the taxpayer on a routine and repetitive basis" must be properly read in the context that they are used. Customized assets that are individually designed are not assets "produced by the taxpayer on a routine and repetitive basis" under § 1.263A-1(h)(2)(i)(D).[3]

Lastly, Taxpayer's argument ignores the underlying history of § 1.263A-1(h)(2)(i)(D). As is explained in Rev. Rul. 2005-53, the history of the section clearly indicates that the simplified service cost method was designed to alleviate the administrative burdens of complying with the new capitalization rules in situations where mass production of assets occurs on a routine and repetitive basis, with a typically high turnover rate for the produced assets. See also T.D. 8131, 1987-1 C.B. 98, 102; Notice 88-86, 1988-2 C.B. 401.[4] Accordingly, the holding of Rev. Rul. 2005-53 is supported by the underlying history of the regulation section.

Issue 2. Is a taxpayer that elects to use the simplified service cost method to determine capitalizable mixed service costs with respect to eligible property required to allocate mixed service costs to property that is not eligible for such method using the methods provided in § 1.263A-1(g)(4)?

Section 1.263A-1(g)(4) provides that using reasonable factors or relationships, a taxpayer must allocate mixed service costs using a direct reallocation method, a step-allocation method, or any other reasonable method (as defined in § 1.263A-1(f)(4)). However, as is explained above, § 1.263A-1(h) provides that a taxpayer may use a simplified method, the simplified service cost method, to determine the aggregate portion of mixed service costs incurred during the taxable year that are properly allocable to "eligible property." For purposes of the simplified service cost method, eligible property is limited to property that is subject to section 263A and that falls within the following categories: (1) inventory; (2) non-inventory property held for sale; (3) self-constructed assets that are substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer that is held primarily for sale to customers in the ordinary

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[3] In Wisconsin Electric Power Company v. EPA, 58 USLW 2463 (7th Cir. 1990), the United States Court of Appeals for the Seventh Circuit upheld the EPA's determination that the company's proposed physical changes to its plant were not routine maintenance, repair, and replacement for purposes of the EPA's regulations. In doing so, the Court found that the EPA's case-by-case determination that weighed the nature, extent, purpose, frequency, and cost of the work, as well as other relevant facts, to arrive at a common-sense finding was not arbitrary or capricious. See Wisconsin Elec. Power Company v. EPA, supra at 910-913. See also United States of America v. Southern Indiana Gas and Electric Company, 245 F.Supp.2d. 994, 999 (S.D.Ind. 2003)(The EPA's routine maintenance exemption analysis entails a fact intensive, case-by-case determination, taking into account factors such as the project's nature, extent, frequency, and cost.); U.S. v. Ohio Edison Co., 276 F.Supp.2d. 829 (S.D. Ohio 2003).

[4] For purposes of brevity, the full history of the regulation section has not been repeated. For further information on the history of § 1.263A-1(h)(2)(i)(D), see Rev. Rul. 2005-53.

course of the taxpayer's trade or business; and (4) self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. See § 1.263A-1(h)(2)(i). Generally, if a taxpayer elects to use the simplified service cost method, it must use the method for all production and resale activities of the trade or business associated with eligible property. See § 1.263A-1(h)(2). However, at its election, a taxpayer can exclude self-constructed assets from application of the simplified service cost method and only apply the method to inventory property and non-inventory property held for sale. See § 1.263A-1(h)(2)(ii). A taxpayer that makes such election must nonetheless allocate service costs to self-constructed assets in accordance with the general allocation rules provided for such costs in §1.263A-1(g)(4). See id.

Under the simplified service cost method, a taxpayer computes its capitalzable mixed service costs by multiplying its total mixed service costs by an allocation ratio. The allocation ratio can be either labor-based or production-based. See §§ 1.263A-1(h)(4) and (5). The production-based ratio is the ratio of the taxpayer's section 263A production costs to its total costs. See § 1.263A-1(h)(5)(i). For this purpose, section 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced and (property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business. See § 1.263A-1(h)(5)(ii). Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See § 1.263A-1(h)(6).

In applying the simplified service cost method, Taxpayer determined that its general plant and intangible assets are not eligible property for purposes of the simplified service cost method. Accordingly, in applying the simplified service cost method Taxpayer excluded section 263A production costs associated with these assets from the numerator of the production cost allocation ratio. Taxpayer also reduced total mixed service costs by the service costs associated with such property. Taxpayer continued to allocate service costs to these assets pursuant to a facts-and-circumstances method that it uses for its books and records. For purposes of the present examination, the Examination Team has accepted that Taxpayer's method of allocating service costs to its general plant and intangible assets as a reasonable method under § 1.263A-1(g)(4).

At its conference of right, Taxpayer argued that the simplified service cost method exempts self-constructed assets that are not eligible property from the statutory requirement to capitalize mixed service costs. Accordingly, Taxpayer argued that (1) it improperly applied the simplified service cost method by excluding production costs of

general and intangible assets from the production cost allocation ratio and service costs associated with these assets from total mixed service costs, and (2) the mixed service costs that it allocated using the simplified service cost method to property that the Examination Team determines is not eligible property must be re-allocated among its inventory and eligible self-constructed assets. In other words, Taxpayer argues that, under the simplified service cost method, all of its capitalizable service costs must be allocated to its eligible property – most of which is electricity inventory that does not remain on hand at year end – and none of its service costs are allocable to ineligible property.

Taxpayer's argument is premised on the definitions of section 263A production costs and total mixed service costs contained in §§ 1.263A-1(h)(5) and 1.263A-1(h)(6) the simplified service cost allocation formula, and the lack of an express rule in the simplified service cost method regulations addressing the treatment of ineligible property. The general allocation formula under the simplified service cost method is the allocation ratio multiplied by total mixed service costs. Taxpayer elected to use the production cost allocation ratio. The numerator of the production cost allocation ratio is "section 263A production costs," which the regulations define as the total costs (excluding mixed service costs and interest) allocable to property produced under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Taxpayer argues that the numerator of the production cost allocation ratio should include production costs associated with all of its assets (including those that are eligible property and those that are not eligible property, such as the general plant and intangible assets and assets that are not produced on a routine and repetitive basis under Rev. Rul. 2005-28)) and total mixed service costs should include all mixed service costs, regardless of whether such costs are associated with property that is not eligible for the simplified service cost method.

To further support its position, Taxpayer asserts that the drafters of the simplified service cost method regulations understood that most of a taxpayer's self-constructed assets would qualify as eligible property and that mixed service costs are more or less fixed costs of the business that do not increase as a result of the rare or occasional production of ineligible property. Thus, according to Taxpayer, the Internal Revenue Service (the Service) and Treasury Department concluded that mixed service costs need not be allocated to ineligible property under the simplified service cost method.

We disagree with Taxpayer's argument that capitalizable mixed service costs are not allocable to ineligible property if the taxpayer to use the simplified service cost method. Taxpayer's proposed application of the simplified service cost method – allocation of capitalizable service costs exclusively to eligible property – is inherently unreasonable and ignores the basic requirement of section 263A, i.e., capitalization of the direct costs and a proper share of the indirect costs of property produced. Section 263A requires producers of real or tangible personal property to capitalize the direct costs and a proper share of the indirect costs of producing such property. See also

§ 1.263A-1(a)(3)(ii). For this purpose, indirect costs include capitalizable service costs, deductible service costs, and mixed service costs. See § 1.263A-1(e)(4).

Taxpayer's argument is also inconsistent with the text of § 1.263A-1(h). Section 1.263A-1(h) provides a method for determining mixed service costs incurred "with respect to eligible property." By its terms, the simplified service cost method only applies to eligible property. See § 1.263A-1(h)(1). Paragraph (h) of § 1.263A-1 does not purport to determine the amount of mixed service costs incurred with respect to other property. Section 1.263A-1(h) does not indicate that the general allocation rule provided by § 1.263A-1(g)(4) does not continue to apply in the case of property that is not eligible for the simplified service cost method.

Moreover, like the simplified service cost method, the simplified production method, provided in § 1.263A-2(b), applies only to "eligible property." Eligible property is defined the same way for both the simplified service cost method and the simplified production method.[5] See §§ 1.263A-1(h)(2)(i) and 1.263A-2(b)(2)(i). More specifically, §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) both provide that self-constructed assets produced on a routine and repetitive basis in the ordinary course of a taxpayer's business are eligible property for purposes of the simplified service cost method and the simplified production method, respectively. Thus, Taxpayer's argument regarding the simplified service cost method also would apply to additional section 263A costs where the taxpayer elected to use the simplified production method. In other words, under Taxpayer's argument it would follow that if a taxpayer elected to use the simplified production method, it would not be required to capitalize additional section 263A costs to ineligible property. The similarities between the simplified service cost method and the simplified production method indicate that Taxpayer's speculation about the Service's and Treasury Department's intent to exempt ineligible property from the requirement to capitalize service costs is incorrect. Even if Taxpayer were correct that service costs do not increase incrementally as a result of producing ineligible property, there is no basis to conclude that would be true of other additional section 263A costs, e.g., indirect materials and labor, insurance, utilities, etc., required to be capitalized.

Taxpayer essentially is arguing that the Service and Treasury Department exempted certain assets from a statutory requirement to capitalize service costs and other indirect costs. There is nothing in section 263A, §§ 1.263A-1(h) and 1.263A-2(b), the preamble to the final regulations, the preambles or texts of the proposed regulations, or Notice 88-86 to support Taxpayer's position.

[5] The simplified production method is a method "for determining the additional section 263A costs allocable to ending inventory of property produced and other eligible property on hand at the end of the taxable year." Additional section 263A costs are the costs other than interest that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A.

Taxpayer points to § 1.263A-1(h)(2)(ii) as evidence that the Service and Treasury Department knows how to write a rule that requires capitalization of service costs to property for which the simplified service cost method is not applied and chose not to draft such a rule for ineligible property. Section 1.263A-1(h)(2)(ii) permits a taxpayer to exclude certain self-constructed assets that are eligible property (i.e., self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer that is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, and self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business) from the application of the simplified service cost method. Section 1.263A-1(h)(2)(ii) expressly provides, however, that if a taxpayer makes this election it is still required to allocate service costs to such property in accordance with the general rules provided by § 1.263A-1(g)(4).

We disagree with the conclusions Taxpayer draws from the existence of § 1.263A-1(h)(2)(ii). The provision in § 1.263A-1(h)(2)(ii) requiring allocation of service costs to property excluded from the election is consistent with the statutory requirement to allocate indirect costs, including service costs, to all property subject to § 263A. The provision is not an arbitrary "rule"; it is simply a reminder that service costs must be allocated to property subject to section 263A notwithstanding the fact that the simplified service cost method will be applied only to some of the eligible property. A similar provision for ineligible property is not expressed in § 1.263A-1(h) because that paragraph only applies to eligible property. The provision in § 1.263A-1(h)(2)(ii) is pertinent to the election to exclude eligible self-constructed assets from the application of the simplified service cost method because the assets excluded from the election are in fact eligible property.

Finally, Taxpayer argues that § 1.263A-1(h) determines the total amount of capitalizable mixed service costs incurred by the taxpayer and allocates the total to eligible property. To the contrary, the simplified service cost method does not purport to determine the total amount of capitalizable mixed service costs incurred by the taxpayer; § 1.263A-1(h) expressly states that the simplified service cost method determines the amount of capitalizable mixed service costs incurred with respect to eligible property. In addition, § 1.263A-1(h)(2)(ii) clearly indicates that a taxpayer that elects to exclude self-constructed assets from its application of the simplified service cost method must nonetheless allocate service costs to such property in accordance with the general rules provided by § 1.263A-1(g)(4). Section 1.263A-1(h)(7) also makes clear that a taxpayer that uses the simplified service cost method for one trade or business and not another must allocate the costs of any mixed service department that supports both trades or businesses between those trades or businesses consistent with the principles of § 1.263A-1(f)(4). See § 1.263A-1(h)(7). Thus, §§ 1.263A-1(h)(2)(ii) and (h)(7) clearly recognize that a taxpayer may incur capitalizable mixed service costs

that must be allocated to property that is not accounted for using the simplified service cost method.

In summary, Taxpayer's arguments concerning the requirement to allocate capitalizable mixed service costs to ineligible property are inconsistent with the statutory language of section 263A, the text of § 1.263A-1(h)(7) and is not supported by the history and evolution of the simplified service cost method regulations. We believe,that the method Taxpayer employed (reducing the numerator of the production based allocation ratio by the section 263A production costs attributable to ineligible property and reducing the multiplicand of the general allocation formula by the mixed service costs allocable to ineligible property on a facts and circumstances basis) is reasonable under the section 263A regulations.

In any event, when Taxpayer filed its Form 3115 it adopted a method of accounting to allocate mixed service costs to ineligible property. As indicated above, we believe that Taxpayer's method is proper. Taxpayer cannot now change that method without consent. See § 446(e).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.